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In the Supreme Court of the United States

OCTOBER TERM, 1955

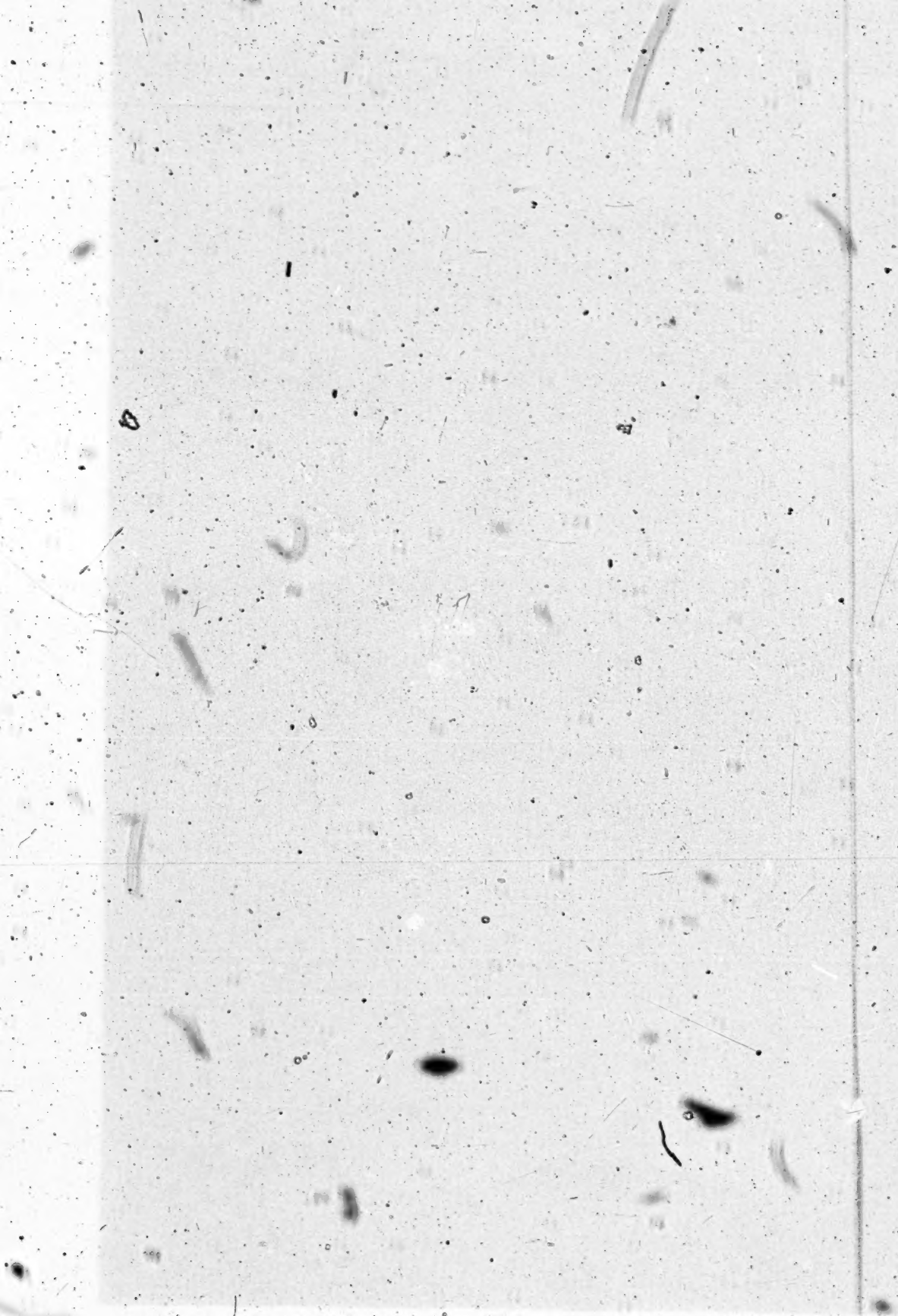
COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER



In the Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

PRELIMINARY

It was pointed out in our main brief (p. 29) that, contrary to the taxpayer's suggestion (Br. 10–14), the Commissioner does not take issue with the underlying facts found by the courts below, but rather challenges only the ultimate conclusion drawn from those facts and the test which was applied in reaching that conclusion. It is not disputed that the ultimate conclusion of the courts below that the taxpayer did not receive taxable income in the nature of compensation was based on application of the so-called "proprietary in-

terest" test.[1] It was also noted in our opening brief (pp. 34–35) that, under such test as applied by the courts below, the immediate economic benefit or gain which the employee receives from his corporate employer through the medium of an employee stock option is held not to constitute taxable income in the nature of compensation only if and when it is found that the employer intended the employee to acquire a proprietary interest in its business. Thus, the finding that the employer intended the employee to acquire a proprietary interest is treated as the decisive factor leading to the conclusion that no compensation is involved, and not, as taxpayer seems to argue (Br. 6–7, 24–25), an inconsequential determination made after the conclusion that no compensation is involved has already been reached. It was further shown in our opening brief (pp. 40–44) that, contrary to taxpayer's argument (Br. 6–7, 24–25), the possession of a proprietary interest on the part of

[1] See R. 146, 160. This test, as the Tax Court defines it, is a principle of law "that upon exercise of such an [employee stock] option the difference between the option price and the market value at the time of the exercise and receipt of the stock constitutes taxable income to the employee at that time if the option was given as compensation * * * but not if it was given to assist him in acquiring a proprietary interest * * *." *Rosenberg* v. *Commissioner*, 20 T. C. 5, 9. It will be noted that compensation as well as a proprietary interest is thus referred to as being "given," making it clear, notwithstanding any implication by the taxpayer to the contrary (Br. 28–29), that in such a context the term "given" is not used to connote a transfer for no consideration.

its employee is never the corporation's sole and final objective precluding any intention to compensate, because, as a practical matter, the corporation does not seek and pay for its employee's acquisition of such an abstract interest as an end in itself, but rather as a means to an end, the end being the concrete reflection of that interest in the services rendered by the employee.

The taxpayer contends that since the early 1930's, the courts have consistently approved the "proprietary interest vs. compensation for services" rule in stock option cases (Br. 6), and that the current Treasury Regulations dealing with such options represent a reversal of prior Regulations without any authority for such a change (Br. 18). The taxpayer also contends (Br. 27) that there is no basis for the Commissioner's argument that the "proprietary interest" test adopted by the courts below would defeat the purpose of Congress in enacting the "restricted stock option" provisions contained in Section 130A of the Internal Revenue Code of 1939 and Section 421 of the Internal Revenue Code of 1954.[2] These contentions would appear to warrant a brief discussion of (1) the judicial and

[2] A further question now raised by the taxpayer for the first time (Br. 2, 5, 29–30)—whether any compensation involved was received and to be measured when the options were granted rather than when they were exercised—is not in this case, since in the proceedings below no such issue was raised (R. 5), or treated as raised, by the pleadings. As pointed out in our opening brief (p. 46), however, there is

regulatory treatment of employee stock options in the past, and (2) the legislative treatment of "restricted stock options" for the future.

JUDICIAL AND REGULATORY TREATMENT OF EMPLOYEE STOCK OPTIONS

With rare exceptions, the cases holding employee stock options to be non-compensatory have involved situations where there was *no* substantial spread between option price and the value of the stock at the time when the option was granted. In these cases the lower courts have offered two principal explanations, one of which—until it was repudiated by this Court in *Commissioner* v. *Smith*, 324 U. S. 177, rehearing denied, 324 U. S. 695—was for a time reflected in the Treasury Regulations dealing with the subject. Under the first or "bargain purchase" explanation, it was held that, on exercising an employee stock option in such a situation, the employee would not receive taxable income in the nature of compensation since he had merely made a bargain purchase. Under the second or "proprietary interest" explanation, which has been previously discussed, some courts (in cases decided prior to *Commis-*

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the further question of when the taxpayer exercised the first two of the three stock options he received—on May 1, 1945, and January 3, 1946, when he gave the corporation his promissory notes payable on March 1, 1947, or on May 24, 1946, when he paid the two notes and received the stock. That question, not reached by the courts below, will be open on remand if the judgment is reversed.

sioner v. *Smith, supra*) adopted a different approach and, instead of stressing the bargain purchase aspect, relied on the employer's desire to grant a proprietary interest as the reason why compensatory income had not been received. The development of these theories and of the applicable Treasury Regulations may be sketched as follows:

From 1923 until 1939, the governing Regulations contained language substantially identical with that set forth in Article 22 (a)–1, Treasury Regulations 94, promulgated under the Revenue Act of 1936, as follows:

> If property is transferred by * * * an employer to an employee, for an amount substantially less than its fair market value, * * * such employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value.

See T. D. 3435, II–1 Cum. Bull. 50 (1923); Article 31, Treasury Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926; Article 51, Treasury Regulations 74 and 77, promulgated under the Revenue Acts of 1928 and 1932; Article 22(a)–1, Treasury Regulations 86, promulgated under the Revenue Act of 1934. Application of these Regulations was not challenged in any case which merely involved acceptance by an employee of a simple offer by his employer to sell him property at a price substantially less than fair market value. In any such case the employer was

free to withdraw his offer at any time prior to its acceptance and it was not questioned that the economic benefit conferred on the employee under those circumstances was intended as compensation. For some time, however, the compensatory character of the economic benefit conferred on the employee was not deemed so clear in the situation where the property was acquired by the employee through the exercise of an option which had become binding on the employer at a time when the option price was not definitely favorable to the employee, i. e., when the option price was not substantially lower than the market price of the optioned property. Accordingly, prior to this Court's decision in *Commissioner* v. *Smith, supra,* a number of decisions had held that in such a situation the employee did not realize taxable income in the form of compensation but merely made a bargain purchase. *Bothwell* v. *Commissioner,* 77 F. 2d 35, 37–38 (C. A. 10th); *Rossheim* v. *Commissioner,* 92 F. 2d 247, 249 (C. A. 3d); *Merhengood Corp.* v. *Helvering,* 89 F. 2d 972, 976 (C. A. D. C.), certiorari denied, 302 U. S. 714; *Evans* v. *Commissioner,* 38 B. T. A. 1406, 1412. These decisions did not take into account that the employer must have realized that his employee, not being bound to exercise the option, would normally exercise it only when it was to his economic benefit to do so. Overlooking that fact, these decisions made no attempt to explain why the corporation was willing to confer such an

economic benefit on its employee as distinguished from anyone else.

In 1939, the Commissioner published his acquiescence in the *Evans* decision. 1939–1 Cum. Bull. 11. At the same time T. D. 4879, 1939–1 Cum. Bull. 159, amended Article 22(a)–1, Treasury Regulations 86 and 94, *supra,* to provide that the difference between fair market value and the price actually paid by the employee should be included in income "to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered." This language was continued in subsequent Regulations: Article 22(a)–1, Treasury Regulations 101, promulgated under the Revenue Act of 1938; Section 19.22(a)–1, Treasury Regulations 103, and Section 29.22(a)–1, Treasury Regulations 111, both promulgated under the Internal Revenue Code of 1939. The Regulations, as so amended, implicitly assumed that there might be a situation, such as that where the option price was the same as or more than the fair market value of the stock when the option was issued, in which the employee, upon being permitted to purchase property from his employer for less than its fair market value could receive an economic benefit from such a "bargain purchase" not in the nature of compensation.

Apparently in attempting to explain why an employer might confer a non-compensatory economic benefit on his employee through the medium of an

employee stock option, a number of decisions—of which those cited in our opening brief (p. 34) are typical—held that such options were not compensatory because they were intended to enable the employee to acquire a proprietary interest. And, although many factors were considered in determining whether particular options were "compensatory" or "proprietary," in nearly all of the cases decided prior to *Commissioner* v. *Smith, supra,* the option was held to be "compensatory" where the market price was substantially in excess of the option price at the time the option was granted to the employee; but where the market price was not substantially in excess of the option price at that time, the option was held to be "proprietary." See Boland, *Employee Options Under the Federal Income Tax,* 28 Taxes 415, 416–417 (1950); Lyon, *Employee Stock Options Under the Revenue Act of 1950,* 51 Columbia L. Rev. 1, 7–8 (1951). Prior to *Commissioner* v. *Smith, supra,* therefore, the principal criterion for determining whether particular stock options were "compensatory" or "proprietary" was the existence or lack of a substantial spread between the option price and market value of the stock when the option was issued.

In 1945, however, this Court's decision in the *Smith* case established, contrary to the argument of the taxpayer in that case, that an employee *could* receive taxable income in the nature of compensation upon making a bargain purchase

through the medium of a stock option even though the market value of the stock did not exceed the option price when the option was issued. Thereafter, any ambiguity in the Regulations was removed by T. D. 5507, 1946–1 Cum. Bull. 18, which, effective with respect to options granted to employees subsequent to February 26, 1945 (the date of the *Smith* decision) amended Section 29.22(a)–1, Treasury Regulations 111, *supra,* to provide that on a transfer of property from an employer to an employee "for an amount less than its fair market value, * * * the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee." By T. D. 5507, the current Regulations were thus brought into conformity with the original Regulations interpreting the statutory definition of gross income.

To summarize this history—prior to T. D. 5507, the proprietary interest explanation was employed principally in cases where, unlike the present one, there was *no* substantial spread between option price and market value when the option was issued or extended. It was only in a few recent cases decided after T. D. 5507 that some courts (with respect to tax years antedating T. D. 5507) employed the "proprietary interest" rationale to hold that there was no compensation even where there was an initial spread.

See *Commissioner* v. *Bradner*, 209 F. 2d 956 (C. A. 6th); *Commissioner* v. *Straus*, 208 F. 2d 325 (C. A. 7th); *Hazleton* v. *Commissioner*, decided April 15, 1953 (1953 P–H T. C. Memorandum Decisions, par. 53,123), appeal dismissed pursuant to stipulation October 19, 1953.[3] Although the issue was not considered ripe for certiorari, the Commissioner consistently adhered to the view that compensation was received by employees in such situations. The case at bar, in which, as pointed out in our opening brief (p. 29), the market value of the stock substantially exceeded the option price both when the options were issued and when they were exercised, is the first one holding under the current Regulations that an employee does not receive taxable income in the nature of compensation through the medium of an employee stock option *if* his

[3] It may be noted that the court which decided the *Straus* case has recently recognized that there is no inconsistency between acquiring a proprietary interest and the receipt of compensation. Thus, the Seventh Circuit in *MacDonald* v. *Commissioner*, decided February 13, 1956 (1956 C. C. H., par. 9284), stated:

> This result [is] not inconsistent with the policy of Household [the employer] in requiring its executive officials to acquire a proprietary interest in the corporation. Taxpayer, like all stockholders of the corporation, acquired such an interest; in fact, the option in connection with the employment agreement served a twofold purpose, that is, it enabled taxpayer to acquire a proprietary interest and at the same time to receive compensation in addition to that which was otherwise provided.

corporate employer intended him to acquire a proprietary interest in its business.

In reaching that conclusion, the Tax Court observed (R. 147) that the Regulations, as amended by T. D. 5507, were not supported by the language of the *Smith* case. This observation confuses the occasion of the amendment in the Regulations with the authority for those Regulations as so amended.[4] The *Smith* case was the occasion of the amendment because it repudiated the "bargain purchase" theory that an employee could not receive taxable income in the nature of compensation upon making a bargain purchase through the exercise of an employee stock option if the market value of the stock did not exceed the option price when the option was issued. The Regulations as so amended, however, like the original Regulations with which they conform, do not depend for their validity solely on the precise holding in the *Smith* case.[5] The authority for the Regulations rests on the broad statutory provisions which they are designed to interpret.

[4] A similar misapprehension was apparently shared by the Senate Finance Committee in the 81st Congress. S. Rep. No. 2375, 81st Cong., 2d Sess., p. 59 (1950–2 Cum. Bull. 483, 526).

[5] Mr. Chief Justice Stone's opinion for the Court in the *Smith* case expressly recognized the comprehensive scope of the statutory definition of income: "Section 22 (a) of the Revenue Act is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." (324 U. S. 177, 181.) To the same effect are the cases cited in our main brief, p. 25.

It has been demonstrated in our opening brief that those Regulations correctly interpret the provisions of Section 22(a) of the Internal Revenue Code of 1939, and that the "proprietary interest" theory has no proper place in that interpretation.

LEGISLATIVE TREATMENT OF "RESTRICTED STOCK OPTIONS"

There remains to be considered the taxpayer's contention (Br. 27) that there is no basis for the argument in our opening brief (pp. 37–39) that adoption of the "proprietary interest" theory of the courts below would defeat the purpose of Congress in enacting the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939 and Section 421 of the Internal Revenue Code of 1954. The taxpayer apparently does not dispute the fact that, when Congress in 1950 added Section 130A to the Internal Revenue Code of 1939, it sought to grant to the so-called "restricted stock option" more preferential tax treatment than that afforded employee stock options generally under the current Regulations. This fact is made clear in the following statements made by the Senate Finance Committee in favorably reporting the bill containing the provisions enacted as Section 130A (S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59–60 (1950–2 Cum. Bull. 483, 526)):

> The rule applied under existing regulations is that an employee exercising an option to purchase stock from his employer

> corporation receives taxable income at the time the option is exercised to the extent of the difference between the market value of the stock at the time of exercise and the option (or purchase) price. * * * .
>
> Under your committee's bill no tax will be imposed at the time of exercise of a "restricted stock option" or at the time the option is granted and the gain realized by the sale of the stock acquired through the exercise of the option will be taxed as a long-term capital gain. * * *

Moreover, it is also clear from the statements made by the Senate Finance Committee in this report, including the very portion which taxpayer quotes (Br. 27), that Congress intended that this preferential tax treatment would be received only by those employee stock options meeting the qualifications and safeguards required of "restricted stock options". These statements further show that the options which Congress regarded as "true incentive" devices "rather than compensation" were only those qualifying as "restricted stock options", i. e., where the option price "approximates the fair market value of the stock at the time the option is granted", so that the option will acquire substantial value only if a favorable spread is developed between the market value of the stock and the option price, thus giving the employee an incentive to give his best efforts in the service of his employer. Accordingly, there is no basis for the taxpayer's

suggestion (Br. 27) that Congress believed that non-restricted "proprietary" options, where the spread already exists, as in this case, were also to be treated as incentive devices involving no element of compensation. Thus, following the above-quoted explanation of the preferential tax treatment to be granted, the Senate Finance Committee report stated (S. Rep. No. 2375, 81st Cong., 2d Sess., p. 60 (1950–2 Cum. Bull. 483, 526–527)):

> Such [favorable] treatment is limited to the "restricted stock option" for the purpose of excluding cases where the option is not a true incentive device. Options which do not qualify as "restricted stock options" will continue to be taxed as under existing law.
>
> Ordinarily when an option is issued as an incentive device, the option price approximates the fair market value of the stock at the time the option is granted.
>
> * * * * *
>
> Since the options which qualify for special treatment are regarded as incentive devices rather than compensation, no deduction is allowed the corporation under section 23 (a) with respect to a transfer of stock pursuant to a restricted stock option.

As pointed out in our opening brief (pp. 37–39), however, under the "proprietary interest" rule applied by the courts below, employee stock options which, like those in the case at bar, do not meet the statutory qualifications and safeguards

required of "restricted stock options" would receive even more favorable tax treatment than the "restricted stock options" themselves, thus clearly defeating the purpose of Congress in enacting the "restricted stock option" provisions.

In the final analysis, if a corporation were to transfer shares of its stock to an employee without requiring any payment, it could scarcely be contended (absent a true gift) that the gain received by the employee was not taxable as income simply because the employer desired him to own a stock interest. Clearly, the situation is no different where, as here, the employee is required to pay part, but not all, of the value of the shares of stock.

The decisive inquiry, as numerous cases in this Court hold, is whether the benefit realized by the employee was a gift. *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 729–730; *Bogardus* v. *Commissioner*, 302 U. S. 34, 39–44; cf. *Commissioner* v. *Jacobson*, 336 U. S. 28, 47–52; *Robertson* v. *United States*, 343 U. S. 711, 713–714; *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426, 432. The triers of the facts should have asked questions like these: Were the options given as an act of "spontaneous generosity"? (*Bogardus*, p. 42.) Is this a case where something was given "for nothing"? (*Jacobson*, pp. 49–51.) Was the employer motivated solely by "affection, respect,

admiration, charity or like impulses"? (*Robertson*, p. 714.) Or, on the other hand, was the employer "interested in its success and in the maintenance of the good will and loyalty of its employees" and did it anticipate a benefit "beyond the satisfaction which flows from the performance of a generous act"? (*Bogardus*, p. 41.)

Had those questions been asked by the triers of the facts, this case would not be here. Review and reversal are required because the lower courts, by asking the wrong question (was this "compensatory" or "proprietary"?), reached the wrong answer.

CONCLUSION

For the reasons stated in our main brief and here, it is respectfully submitted that the judgment of the court below should be reversed.

Respectfully submitted,

SIMON E. SOBELOFF,
Solicitor General.
CHARLES K. RICE,
Acting Assistant Attorney General.
PHILIP ELMAN,
Assistant to the Solicitor General.
HILBERT P. ZARKY,
JOSEPH F. GOETTEN,
Attorneys.

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